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CHARLES ELMORE

No. 163.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1932.

ATLANTIC CITY ELECTRIC COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONER.

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AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONER.

The petitioner relies for its main brief herein upon the brief filed in support of its petition for a writ of certiorari and begs leave to file this brief in answer to the brief of the respondent. Since the petition for certiorari was filed the record herein has been reprinted. The findings of fact made by the Board of Tax Appeals showing the relations between the American Gas and Eelctric Company and the taxpayers are printed at pages 15 to 19, and the stipulation of counsel showing the amounts of the net incomes of the taxpayers during the taxable years is printed on page 33 of the record as reprinted.

I.

The American Gas and Electric Company owned or controlled all or substantially all the stock of the taxpayers.

The changes which Congress has made in the Revenue Acts with reference to the use of consolidated returns do not seem to us to help the respondent. The Revenue Act of 1921 (Sec. 240) gave to affiliated corporations the option

to make separate returns or a consolidated return for taxable years beginning on or after January 1, 1922, but it left the test of affiliation the same as in the Revenue Act of 1918. For the years 1917 to 1921 during which the excess profits tax was in force, affiliated corporations were required to make consolidated returns, but for the years after 1921 when only the income tax was in force, affiliated corporations were permitted to make either separate returns or a consolidated return.

The Revenue Act of 1924 (Sec. 240) changed the test of affiliation from *ownership or control* of *substantially all* the stock to *ownership* of at least *95 per centum* of the *voting* stock. The Revenue Act of 1926 (Sec. 240) changed the test of affiliation to ownership of at least 95 per centum of the stock, but provided that the term "stock" should not include "non-voting stock which is limited and preferred as to dividends".

The Revenue Acts of 1928 and 1932 (Sec. 241) eliminated as a test of affiliation the ownership of stock by individuals and limited the test to the ownership of stock directly or indirectly by a corporation.

There is no doubt that these changes in the wording of the law indicate an intention on the part of Congress to change the substance of the law rather than to interpret a prior law. They do not furnish any ground for the argument that the words "substantially all the stock" as used in the Revenue Acts for 1917 and 1918 meant 95 per centum of the stock. They tend on the contrary to show that the words "substantially all the stock" as used in the earlier acts meant something less than 95 per centum of the stock. They show an intention to make the test of affiliation more definite than it had been and recognize that the test laid down in the Revenue Acts for 1917 and 1918 was broad and flexible.

The respondent argues that 77 per cent of the stock of a corporation is not substantially all of its stock within the meaning of the Revenue Acts for 1917 and 1918 but does not indicate what percentage would be substantially all of its stock within the meaning of those statutes.

The respondent also argues that it makes no difference whether the outstanding stock of the subsidiary corporation is preferred or limited as to dividends or redeemable at the option of the parent corporation, and that the word "stock" as used in these statutes includes every kind of voting stock but no kind of non-voting stock. There may be cases where the question whether the outstanding stock has voting power would have a bearing upon the matter of consolidation for tax purposes, but we cannot see how it makes any difference in this case whether the preferred stock of the taxpayers had voting power or not. The American Gas and Electric Company had the absolute power to elect the entire Board of Directors of each of the taxpayers and thus to control every detail of management. The power of the preferred stockholders to vote did not increase in any way their interest in intercorporate dealings or their right to question them.

Furthermore, if it is possible to construe these statutes so as to eliminate from consideration non-voting stock, we submit that it is equally possible to construe them so as to eliminate from consideration limited and redeemable preferred stock.

The respondent seems to recognize that the purpose of these statutes was to secure substantial equality as between the stockholders who bore the burden of the taxes and to prevent the evasion of taxes through arbitrary intercorporate dealings and that Articles 631 and 633 of Regulations 45 of the Treasury Department were valid and appropriate to carry out this purpose. The respondent argues, however, that the preferred stockholders of the taxpayers did bear some part of the burden of the taxes and that the existence of this stock was an effective check against diversions of income through price fixing, charges for services or other arbitrary intercorporate dealings.

The figures show convincingly that the preferred stockholders of the taxpayers bore no part of the burden of the taxes. In the case of the Atlantic City Company the net income for the years 1917 to 1919 averaged more than

$152,000, the taxes for these years as assessed by the Commissioner upon the basis of separate returns and before they were reduced by the Board of Tax Appeals averaged only $18,714, and the preferred dividend requirements amounted to only $22,200 per annum. In the case of the Scranton Company the net income for the years 1917 to 1919 averaged more than $610,000, the taxes for those years as assessed by the Commissioner upon the basis of separate returns, and before they were reduced by the Board of Tax Appeals averaged only $126,365, and the preferred dividend requirements amounted to only $64,200 per annum (R. pp. 15-16, 33). It is obvious that the preferred stockholders had no practical interest in the amount of the Federal taxes.

These figures also show convincingly that the preferred stockholders had no interest in any diversions of income which the American Gas and Electric Company might have made through price fixing, charges for services or other intercorporate dealings. The American Gas and Electric Company was entitled to all the earnings of the taxpayers in excess of the dividends upon their preferred stock, and it did not make any difference to the preferred stockholders whether the American Gas and Electric Company received these excess earnings through the declaration of dividends upon the common stock or through price fixing, charges for services or other intercorporate dealings. The preferred stockholders would have no interest in such dealings and no reason to take notice of them unless they involved a diversion of the greater part of the earnings and thus threatened the safety of their dividends. The plain fact is that the existence of this preferred stock was not an effective check or any kind of a check against the evasion of taxes through intercorporate dealings. If the American Gas and Electric Company had desired to do so, it could have diverted by intercorporate dealings one-half or three-quarters of the incomes of the taxpayers before the preferred stockholders would have been moved to take any action to interfere with such dealings.

We contend that the test of affiliation laid down in the Revenue Acts for 1917 and 1918 was broad and flexible, that it should be interpreted in the light of the purpose of the statutes, and that under such an interpretation the common stocks of the taxpayers were substantially all their stocks.

Our contentions are fully supported by Sections 631 and 633 of Regulations 45 of the Treasury Department which have received not only the sanction of the Respondent, but also that of the Supreme Court. It was stated in *Handy & Harman* v. *Burnet,* 284 U. S. 140, that the purpose and intention of the statutes in question "was given effect by the regulations contemporaneously promulgated," including specifically Articles 631 and 633 of Regulations 45.

Article 633 of Regulations 45 states specifically that the words "substantially all the stock" cannot be interpreted as meaning any particular percentage but "must be construed according to the facts of the particular case," that consolidated returns may be required even though the stock ownership or control is less than 95 per cent., and that when the stock ownership or control is less than 95 per cent. but in excess of 50 per cent., a full disclosure of the facts must be made. There could be no purpose in such a disclosure other than to enable the Commissioner to determine the question of affiliation according to the facts of the particular case. These provisions show clearly enough that in some particular cases the words "substantially all the stock" might mean any percentage in excess of 50 per cent.

As the fundamental purpose of the statutes as stated in Article 631 of the Regulations, and the opinion of the Supreme Court in *Handy & Harman* v. *Burnet, supra,* and as conceded by the respondent in his brief, was to determine the true net income and invested capital of a single business enterprise, even though the business was operated through more than one corporation, and to prevent inequalities or evasions which might result from price fixing, charges for services or other intercorporate dealings, it is obvious that

a parent corporation is always affiliated with a subsidiary corporation within the meaning of these statutes, unless the outstanding stock of the subsidiary is of such a quantity and such a character as to be an effective check against such intercorporate dealings. When the outstanding stock is common stock and of the same class as that held by the parent, a relatively small amount of it might be an effective check, but when the outstanding stock is only preferred stock which is limited as to dividends and redeemable at the option of the parent, and the earnings of the subsidiary exceed its preferred dividend requirements many times over, no amount of such stock would be an effective check.

The preferred stocks of the taxpayers were high grade investment stocks. They appealed to investors who were looking for safety of principal and safety of income and did not want to be bothered with questions of management. The holders of this stock had no power to elect a single director or take any part in the management.

The ownership of the common stock gave the American Gas and Electric Company the power to elect all the directors and absolute control over the business and management of the taxpayers. The record shows that it actually supervised and regulated the details of the business. The officers and directors of the three companies were practically the same individuals and the taxpayers did nothing of any importance without the approval of the American Gas and Electric Company. The preferred stockholders never made any objection to anything that was done (R. pp. 17-18).

We contend that the common stock of the taxpayers was substantially all their stock within the meaning of the Revenue Acts and that the ownership of this common stock by the American Gas and Electric Company was enough to constitute an affiliation, without reference to whether the power to redeem the preferred stocks carried control over those stocks within the meaning of the Revenue Acts. We submit,

however, that the power to redeem did carry control over those stocks within the meaning of the Revenue Acts.

It may be conceded that until the power to redeem is exercised, the owners of the stock have the right to sell or otherwise dispose of it and to collect dividends and to vote thereon as freely as any other owners. It is true, nevertheless, that the power to redeem carries control over the stock. It includes power to take the stock away from the owners at any time and put it out of existence. This power is conferred by the charter and inherent in the stock. It is hard to see how any one person could have any more effective control over stock which belonged to another. It is true, of course, that it carries no beneficial ownership but the Revenue Acts for 1917 and 1918 did not make ownership the test of affiliation. They provided specifically that two corporations were affiliated if one owned or controlled substantially all the stock of the other.

The record shows that these preferred stocks were redeemable at any time by vote of the common stock, that the American Gas and Electric Company owned the common stocks of thirty or forty different lighting and power companies, that the par value of the preferred stocks of the taxpayers amounted to only $1,440,000 (R. pp. 16-17) and that the net incomes of the taxpayers for the three taxable years exceeded $2,288,000 (R. p. 33). There is no ground for the inference that the American Gas and Electric Company was not in a position to redeem these preferred stocks if it had desired to do so.

The case of *Peytona Lumber Co.* v. *Commissioner,* cited by the Respondent is not in point. In that case, H and M each owned 50% of the stock of one corporation. Prior to its organization they agreed orally that the management should be left to M and that M might at any time acquire the stock of H at cost plus interest. M owned or controlled substantially all the stock of another corporation. It was held that the two corporations were not affiliated. It does not appear that the stock covered by the option was delivered to M or deposited in any way under the option. The decision is based

upon the ground that M had no control of H's stock enforcible at law or otherwise and that the same interests were not "the beneficial owners in like proportions of substantially all the stock of each of said corporations", within the language of the Supreme Court in the *Handy & Harman* case. It is obvious that an option to acquire stock which is not deposited with or for the benefit of the optionee is very different from a right to redeem stock under a charter provision. Under such an option the right of the optionee may be defeated by a sale of the stock to an innocent purchaser for value and the nature of the control is temporary and incomplete. Under such a charter provision the right to redeem is binding upon all holders whether they acquired the stock with or without notice and the nature of the control is permanent and complete. Such a right to redeem affects the inherent nature of the stock itself.

It is important throughout to note the differences between the two grounds for affiliation which are contained in the Revenue Acts, the first applying when one corporation owns or controls substantially all the stock of another or others, and the second applying when substantially all the stock of two or more corporations is owned or controlled by the same interests. The case at bar involves the first ground, but the *Handy & Harman* case, the *Howes Brothers* case and the *Peytona Lumber* case involved the second ground. When affiliation depends upon the second ground the statute is not satisfied unless the same interests own or control substantially all the stock of the corporations *in like proportions*. It is obvious that this requirement was not satisfied in the *Handy & Harman* case, the *Howes Brothers* case or the *Peytona Lumber* case and that it is not applicable to the case at bar.

II.

This case does not fall within the exception of the Revenue Act for 1917 relating to public service corporations.

It is a well established rule that an exception in a statute should be construed strictly, that such an exception takes no case out of the enacting clause which does not fall fairly within its terms and that a party who claims the benefit of such an exception has the burden of proving that his case falls within its terms.

> *U. S.* v. *Dickson,* 15 Pet. 141;
> *Schlemmer* v. *Buffalo R. & P. Ry. Co.,* 205 U. S. 1;
> *Baltimore & O. S. W. R. Co.* v. *U. S.,* 242 Fed. 420;
> *Thompson* v. *United States,* 258 Fed. 196;
> *Hopkins* v. *U. S.,* 235 Fed. 95.

In *Schlemmer* v. *Buffalo R. & P. Ry. Co., supra,* Mr. Justice Holmes said:

> "'The general rule of law is, that a proviso carves special exceptions only out of the body of the act; and those who set up any such exception must establish it,' etc. *Ryan* v. *Carter,* 93 U. S. 78, 83. *United States* v. *Dixon,* 15 Peters, 141, 165. The rule applied to construction is applied equally to the burden of proof in a case like this. *United States* v. *Cook,* 17 Wall. 168; *Commonwealth* v. *Hart,* 11 Cush. 130, 134."

It follows that the respondent has the burden of proving that this case falls within the exception in Section 1331 of the Revenue Act of 1921. The respondent also has the burden of showing that the decision of the Board of Tax Appeals was wrong. The result is that if the record does not contain the facts necessary to show that this case falls

within the exception in Section 1331, it must be held that it does not fall within the exception.

The contentions now made by the Respondent with respect to the exception in Section 1331 were not made before the Board of Tax Appeals or considered by that Board. No such contention is suggested by the assignments of error, which relate only to the question whether the Atlantic City Company or the Scranton Company was affiliated with the American Gas and Electric Company for the three taxable years (R. pp. 27-8).

The record shows that the American Gas and Electric Company was a holding corporation and not a public service corporation (R. pp. 16-7). It also shows that the taxpayers were not operated independently of the American Gas and Electric Company. The operations of the former were controlled by the latter (R. pp. 17-8).

The record shows that the Atlantic City Company was formed by the consolidation of several lighting, heating and power companies operating in and around Atlantic City, and that the Scranton Company was formed by the consolidation of several lighting, heating and power companies operating in and around Scranton. It does not show specifically that either of these companies was a public service corporation and certainly does not show that they were operated independently or that they were not physically connected (R. 16-8).

The record shows that the American Gas and Electric Company was the owner of all the common stock, including a majority of the voting stock, of from thirty to forty lighting and power companies in the Atlantic and Middle states, including the Atlantic City Company and the Scranton Company (R. 16-7). The inference is that the American Gas and Electric Company operated all these companies in harmony with each other and as economically as it could. They were all parts of one system or enterprise and it is obvious that harmonious operation and physical connection would be economical and otherwise advantageous. It is

entirely possible that some of these corporations were located between Scranton and Atlantic City and that they were all connected physically by transmission lines or otherwise so that they could make exchanges of power and other facilities according to their varying needs.

Even if it were assumed that the Scranton Company and the Atlantic City Company were operated independently and were not physically connected, it would not follow that this case fell within the exception of the statute. The question involved here is not whether these two corporations were affiliated with each other but rather whether they were affiliated with the American Gas and Electric Company. This was recognized throughout the opinion of the Board of Tax Appeals and the petition for review (R. 25-8). There are two separate cases, one between the Respondent and the Scranton Company and the other between the Respondent and the Atlantic City Company, each one involving separately the question whether the taxpayer in that case was affiliated with the American Gas and Electric Company.

It is clear that the exception in the statute applies only to the affiliation of two or more public service corporations *with each other,* and that it does not apply to the affiliation of such a corporation with *some other corporation* which owns or controls it. Any other interpretation would lead to an absurd result. Suppose, for instance, that it were held that the Atlantic City Company and the Scranton Company were not affiliated with each other, although each was affiliated with the American Gas and Electric Company, and that they could not both be included in a group with the American Gas and Electric Company for tax purposes, how could anybody determine which one should be included and which one excluded? Each would have the right to claim the benefit of affiliation with the American Gas and Electric Company and the Commissioner certainly would have no power to determine arbitrarily that one should have such benefit and the other not.

It should be noted that the exception in the statute applied only in cases where public service corporations (1) were operated independently, (2) were not physically connected or merged, AND (3) did not receive special permission to make a consolidated return. In order to bring this case within the exception, it is necessary for the Respondent to show that all three of these conditions existed. It is not enough for him to show that some one of them existed. The form of the exception is conjunctive and not disjunctive.

III.

The decision of the Circuit Court of Appeals should be reversed and that of the Board of Tax Appeals should be affirmed.

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